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SCOTTSDALE CITY COUNCIL

Herbert Drinkwater, Mayor
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**SCOTTSDALE WATER SERVICE
COMPANY CONTRACT COMPLIANCE**

The City contracted to privatize the design, construction, ownership and operation of a water treatment plant in an effort to provide traditional services through a cost-effective method. Although significant advantages of the privatization were achieved, the City may not have realized certain benefits of the effort. This report presents findings related to the City's experiences in the privatization.

**Report No. 8802C
January 1994**

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**SCOTTSDALE WATER SERVICE COMPANY
CONTRACT COMPLIANCE REVIEW
ACTION PLAN**

No.	MANAGEMENT RESPONSE		IMPLEMENTATION STATUS		PROPOSED RECOMMENDATIONS
	AGREE	DISAGREE	UNDERWAY	PLANNED	
1	X		X		<p>The City Manager should pursue options to ensure that appropriately qualified personnel are assigned to protect the City's best interest in unique contractual arrangements. Such assigned personnel should be allocated adequate time to identify significant contract terms and to periodically verify and document compliance with those terms. The personnel should be responsible for accumulating and maintaining control of all significant contract documents and background information.</p> <p>The Water Resources General Manager should pursue options to negotiate revisions to the Service Agreement to provide the City a role in ownership and operation of the plant. The monetary audit findings presented in this report should be addressed in any such negotiations.</p>
2	X		X		



January 11, 1994

To the Most Honorable Herbert R. Drinkwater, Mayor
and the Members of the Scottsdale City Council:

Transmitted herewith is the Scottsdale Water Service Company Contract Compliance Report No. 8802C. This audit was a scheduled project approved by City Council as part of the City Auditor's 1988 audit program. Ramon Ramirez acted as auditor in charge on this project.

Audit work was conducted in accordance with generally accepted government auditing standards as they relate to expanded scope auditing in a local government environment and as required by Article III Scottsdale Revised Code §2-117, *et seq.*

If you need additional information or have any questions, please feel free to contact the Office at 994-7756.

Respectfully submitted,

A handwritten signature in cursive script that reads "Cheryl Lu Barcala".

Cheryl Barcala, CIA, CPA, CFE

dg

EXECUTIVE SUMMARY

Scottsdale Water Service Company
City Auditor Report No. 8802C

January 11, 1994

To the Most Honorable Herbert R. Drinkwater, Mayor and
the Members of the Scottsdale City Council:

This report presents findings related to the City's experience in privatizing the design, construction, ownership and operation of the water treatment plant that processes water allocated to the City by the State and delivered through the Central Arizona Project (CAP). The City contracted with the Scottsdale Water Service Company Limited Partnership (the Partnership) to provide these services.

Since 1987, the Partnership has provided water treatment services that met contract specifications. The Water Resources General Manager characterized the Partnership as a good plant operator. Additionally, under Partnership management, plant construction was completed ahead of schedule at a cost below original estimates. However, we found that based on certain interpretations of contract language, the City may not have realized certain benefits of the effort. This report identifies audit findings related to the privatization.

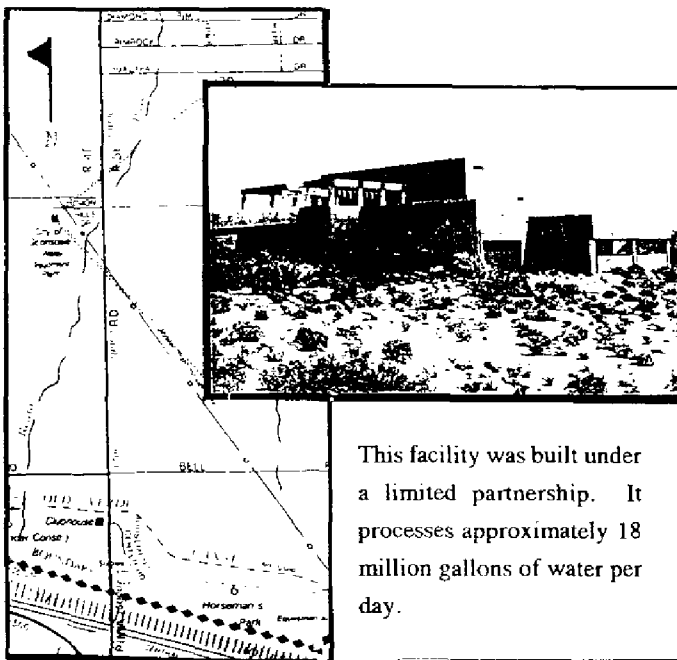
In 1992, the Water Resources General Manager began negotiating with the Partnership for contract changes necessary to afford the City direct control over the management and operations of the facility. Audit findings and questions were forwarded to him for consideration in his efforts to renegotiate the contract. Settlement on the findings and all questions raised during the audit was accomplished through this process.

Audit fieldwork began in late October, 1991 and was completed on September 30, 1992. The audit was conducted in accordance with generally accepted government auditing standards as they relate to expanded scope auditing and as required by Article III Scottsdale Revised Code §2-117 *et seq.* subject to the limitations outlined in Objectives, Scope and Method located in Appendix A.

Background In early 1984, City staff began evaluating the potential of privatizing a water treatment facility in north central Scottsdale. Privatization was a new concept being

advanced by the federal government and others as a cost-effective method of providing traditional services. Because of potential federal tax advantages available in a privatization but not available to municipalities, the City formed a task force to explore and solicit interest from private companies that could construct (own) a treatment plant and process water for lower cost. The concept was that such a concern could take advantage of four factors to reduce its federal tax burden and financing costs and in effect reduce costs to the City. (See Below.)

CAP WATER TREATMENT PLANT
(8660 E Union Hills Drive)



This facility was built under a limited partnership. It processes approximately 18 million gallons of water per day.

MAJOR ADVANTAGES TO PRIVATIZATION

- 1) The project could be financed with bonds that would pay interest exempt from federal taxes.
- 2) Funds could be borrowed at a lower interest rate.
- 3) Investment tax credit would be available on the plant.
- 4) The facility could be depreciated for tax purposes.

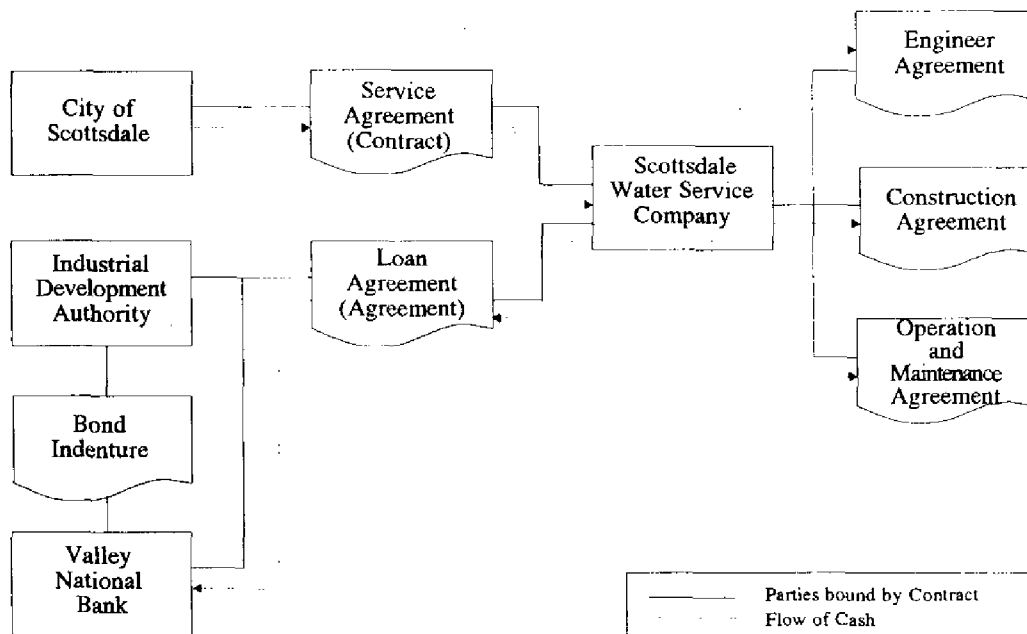
*Selection Of The
Private Enterprise*

Based on task force recommendations, the City chose to privatize the proposed water treatment facility. In August 1984, the City called for qualification statements from interested firms. Over 130 people, some representing national and international construction/engineering ventures, attended a required pre-submittal meeting held in early September. Subsequently, 14 groups submitted qualification statements. The statements contained detailed financial, organizational, and experience statements delineating their respective design, construction, ownership, and operating experience. Using 40 evaluation criteria and interviewing 120 cited references, the 14 submittals were reduced to a short list of 5 firms (groups). These 5 respondents then submitted concepts, plans, and packages containing their proposed privatization process and drafts of the required contracts. Each respondent then made a full oral presentation to City staff. Based on this evaluation process staff recommended, and the City Council approved, selection of the Partnership for the privatization.

Structure Of The Deal

In December 1984, the City entered into a Service Agreement (Contract) with the Partnership to design, construct, operate and own a water treatment facility. Currently, the facility is capable of processing a minimum of 18 million gallons of the City's CAP allocation. The design and construction of the project was financed by proceeds from the sale of industrial development revenue bonds issued by the Industrial Development Authority of the City of Scottsdale. The Authority issued \$25,000,000 in bonds, and under the terms of its Loan Agreement (Agreement) with the Partnership, made the proceeds available for the project. The Agreement sets out the terms for use of the proceeds and the terms and schedule for repayment of the loan. The bond proceeds were used to pay for all construction, design, financing, and credit enhancement costs, and to pay the Partnership a 5 percent privatization fee of \$1,250,000. (See Exhibit I.)

EXHIBIT I Water Treatment Facility Privatization



City of Scottsdale

- Contracted with the Partnership for the design, construction, ownership, and operation of the water treatment facility.
- Paid fees to cover all bond and plant costs as well as a management fee.

Industrial Development Authority

- Loaned \$25 million of bond proceeds.
- Restricted use of bond proceeds in the Loan Agreement.
- Assigned the Loan Agreement to Valley National Bank.
- Established Valley National Bank as bondholder trustee.

Valley National Bank

- Verifies compliance with the Loan Agreement.
- Bills for debt service on outstanding bonds.

Scottsdale Water Service Company

- Financed facility design and construction with bond proceeds.
- Entered Engineer Agreement (with an affiliate of one of its partners) for facility design.
- Contracted for construction and operation of the facility.
- Bills costs and management fee to the City.
- Forwards money to the trustee to service bond debt.

SOURCE: Audit Analysis

The selection of the Partnership and negotiation of the Contract took place in a compressed time frame. On November 19, 1984, the City Council authorized negotiation of a final draft and on December 3, 1984, the Contract was approved. It was signed by all parties 15 days later. The schedule was driven by Internal Revenue Code changes effective January 1, 1985, that imposed use restrictions and issuance limitations on Industrial Development Bonds. If the financing was not finalized before the end of the calendar year, sufficient financing resources might not have been available for the project.

The City's Financial Obligations

The Agreement obligates the Partnership to repay the bond proceeds along with interest; however, the City, in effect, services the debt on the loan under the terms of the Contract by paying fees to the Partnership designed to cover repayment of the bonds and related interest, other financing costs, operating and maintenance expenses, and administrative expenses. The fees paid by the City also include a management fee, for the Partnership, equal to 7.5 percent of plant operating and maintenance costs incurred during the month.

The Contract is renewable annually, however, if the City chooses not to renew it, the City may not construct, purchase or contract for substitute water treatment services. These restrictions were intended to prevent the City from terminating the contract before 2008.

After July 1, 2008, the City has the option to purchase the Partnership's entire interest in the plant at fair market value. By that time the City will have provided the monies to repay all the bonds. Should the City exercise its option to buy the plant after July 1, 2008, we could effectively pay for the plant twice. However, construction cost savings, early plant completion, and other privatization benefits should be considered in assessing the fiscal impact on the City. Projections related to the potential market price of the plant in 2008 were as high as \$60 million.

**City Staff Did Not
Provide Assurance Of
Contract Compliance**

After Contract negotiations, the City did not immediately position itself to adequately manage contract administration duties. Even though the City assembled a task force that was capable of dealing with most of the issues raised during the negotiation process, contract implementation could have been improved.

Within six months after the Contract was signed, the task force chair and another key task force member left City employment. The remaining managers assumed that other contract parties would respect the City's interest. No one at the City was assigned contract administration duties related to interpreting the terms, verifying compliance or managing pertinent documentation until 1987.

*Key Documents Not
Retained Within The City*

During the initial document gathering phase of this audit, it became apparent that nowhere in the City was there a complete set of the significant documents related to the project. According to City personnel, the absence of a comprehensive set of documents was most likely the result of the City's understanding of bond counsel advice to distance itself from project ownership and control to preserve the integrity of the tax advantages.

Recommendation

The City Manager should pursue options to ensure that appropriately qualified personnel are assigned to protect the City's best interest in unique contractual arrangements. Such assigned personnel should be allocated adequate time to identify significant contract terms and to periodically verify and document compliance with those terms. The personnel should be responsible for accumulating and maintaining control of all significant contract documents and background information.

Abbreviated Response Management agrees. Steps have been taken to assure that the City's interests are served.

**The City May Not Have
Realized Its Full Share
Of Funds Under The
Contract**

The terms of the Contract required the Partnership to "use its best efforts to obtain investors...who will acquire limited partner interests in SWSC...and agree to make payments therefore...terms of the offering...shall be determined by SWSC in its sole discretion." The enticement to potential investors was the tax benefits that could be gained in becoming a partner. Specifically, tax benefits were available through an investment tax credit as well as accelerated depreciation that could be taken on the plant. The Contract required that the net proceeds (gross sale proceeds less sale expenses and related taxes) of any sale of limited partnership interest be equally shared with the City.

Ford Motor Credit Company was the only investor in the limited partnership, paying \$6,926,729 for its partnership interest. From that amount, the Partnership deducted a total of \$2,749,771. As identified by the Partnership, \$622,920 was for related sale expenses and \$2,126,851 was for income taxes incurred in the sales transaction. Fifty percent of the remaining \$4,176,958 (\$2,088,479) was then provided to the City as our share of the sales. The City used these funds to reduce the outstanding bond debt.

*Funds Due To The City From
Limited Partnership Sale May
Have Been Understated*

The Contract provides for sales proceeds to be used to pay income tax expense resulting from the limited partnership sale transaction. The sale transaction did not result in any income tax expense to the Partnership or its partners. However, in a separate transaction related to the receipt of the sale proceeds, the Partnership paid a \$4,215,330 development fee to its partners for services provided since the inception of the privatization. This development fee included \$2,126,851 to pay the partners' income taxes related to their receipt of the development fee monies.

Along with the allowable expenses of the limited partnership sale transaction, the income tax portion of the development fee was deducted from the total amount to

arrive at the amount divided between the Partnership and the City. The deduction of the income tax expense related to the development fee payout was not consistent with our interpretation of applicable contract terms. External legal counsel assessed our interpretation as plausible.

Based on this interpretation, the City could have received an additional \$1,063,425 (half of the \$2,126,851 deducted as income tax expense) from the Partnership. Interest income also would have accrued to the City on these funds had they been in the City's possession.

*Litigation Reserve Established
With Funds Due To The City*

The Partnership established a \$100,000 reserve for tax litigation with a portion of the limited partnership sales proceeds and deducted the amount as expense in the calculation for the distribution of the sales proceeds. This reserve was established to reflect the Partnership's contractual obligation with Ford to pay tax litigation costs in regard to an audit of the partnership's federal income tax returns, should any such costs arise. This obligation was a requirement of the limited partnership sale, but it was not an expense of the sale. The reserve was established to meet potential expenses. However, the establishment of a reserve and the use of the limited partnership sales proceeds to fund it was not approved by the City. The effect of this approach was a \$50,000 reduction of the funds received by the City in 1988 from the limited partnership sales transaction.

According to the Partnership, it has not been necessary to use the reserve funds to date. The funds are intact and under the control of the Partnership. It has been over five years since the reserve was established and with the passage of time the chance that use of the funds may be required diminishes.

The City and the Partnership agree that a portion of the reserve has been held by the Partnership for the City. Therefore, the City is due \$50,000 from the Partnership as

its share of the unused litigation reserve. Interest income has accrued on these funds while under Partnership control and is also due to the City.

*Interest Earned On City
Portion Of Bond Proceeds
Still Outstanding*

Upon the sale of the limited partnership interest, 50 percent of the net sales proceeds were to be made available for the City's benefit. The Partnership maintained control of these funds for approximately 14 months before they were remitted to the City. During the time the proceeds were held by the Partnership, the funds earned interest. Analysis of pertinent bank statements indicated that approximately \$157,139 in interest was earned on the monies during that time.

Recognizing the City's right to interest earned on the funds, the Partnership credited the City \$125,778 on its December, 1987 billing. The remaining \$31,361 of interest earned on the City's funds has not been credited to the City. Information provided by the Partnership indicates that the \$31,361 was kept to fund Partnership working capital needs. According to Contract terms, the City could be responsible for providing working capital to the Partnership if the City and the Partnership so agree. However, the City never agreed to be responsible to provide the Partnership with working capital. Therefore, our analysis indicates that the City has no obligation to provide any such working capital.

Based on this analysis, the City was due \$31,361 from the Partnership for the interest earned on City funds while under the Partnership's control. Interest income on the funds also would have accrued to the City had they been in the City's possession.

**No Incentive Exists
To Hold Operating
Costs To A Minimum**

The Contract requires the City to pay virtually all plant costs. These costs include debt service on the bonds used to finance construction of the plant, administrative, operating and maintenance costs. With few exceptions, the City bears all costs.

The Contract requires the Partnership to exercise due diligence in the management of operations at the water treatment plant. This includes reviewing the accuracy of invoices sent to the City for the monthly operating fee. A prior City audit of the utility bills and tariff costs billed to the City by the Partnership's operator identified \$367,236 (including interest and management fees) in overcharges.

Based on our interpretation of applicable contract language, the City is due \$179,946 from The Partnership as reimbursement for audit cost incurred to uncover these overcharges. Interest income also would have accrued to the City if these funds were in the City's possession.

Recommendation

The Water Resources General Manager should pursue options to negotiate revisions to the Contract to provide the City a role in ownership and operation of the plant. The monetary audit findings presented in this report should be addressed in any such negotiations.

Abbreviated Response

Management agrees and has proceeded to implement the recommendation.

APPENDICES

APPENDIX A

Objective, Scope And Methodology

This is the third in a series of three audit reports initially designed to assess the City's utility account management practices. The scope of this audit series was expanded to include a review of the practices of the Partnership in its role in securing the design and construction of a water treatment plant in north central Scottsdale. Audit analysis was expanded to cover events and activities that are nearing the statute limit for legal remedy. If such events and activities were not included in this review, the statute of limitations could bar pursuit of any contract breaches that may exist.

Design and construction activities were initiated in December 1984, and continued until approximately December 1986, at which time construction of the water treatment plant was complete. This review covered all design and construction activities that took place during that period. Also included was the Partnership's compliance with the terms of the Contract which was signed by the Partnership and the City on December 18, 1984, and has been renewed annually since then. It also encompasses all significant events that occurred under the Contract since its inception up to the end of fieldwork: September 30, 1992.

Preliminary audit work began in mid May 1991. The gathering of all documents pertinent to the project was the necessary first step in this review. The complex structuring of the privatization, the number of parties involved, the age of the project and the lack of a focal point at the City, for an extended period during the early phases of the contract, were all contributing factors to a lengthy document gathering process. Because key employees involved in coordinating the City's efforts were no longer with the City, it was difficult to ascertain who the significant participants outside the City were. Moreover, once the outside participants were identified, it was a time consuming process to arrange meetings with them or to get approval for access to the pertinent documents that were in their possession.

Because of the financial structure of the privatization, some of the significant parties involved viewed the City as a nonparticipant. In such instances, the outside parties requested formal approval from the Partnership before we were given access to pertinent documents. As a result, some facets of fieldwork could not begin until late October, 1991. As the audit progressed additional documentation came to light. Obtaining this material proved to be a similarly time consuming process. Audit fieldwork was completed on September 30, 1992. Concluding analysis and report drafting was delayed while staff was temporarily reassigned to an unrelated project requested by City management.

The majority of the monetary issues identified in this report were premised on contract interpretations which conflict with the Partnership's application of contract terms. The City Attorney's Office was consulted in this analysis. To confirm interpretations of significant contract language, we consulted with the outside law firms of: 1) Mariscal, Weeks, McIntyre and Friedlander, and 2) Meyer, Hendricks, Victor, Osborn and Maledon.

To gain insight into the evolution of this project at the City, the scope of this review included interviews with current and former City employees as well as with a representative of Boyle Engineering Corporation (formally under contract with the City). Technical advice was solicited from representatives of Tri Stem, Incorporated, the City of Fort Worth, Texas Internal Audit Department, R. L. Townsend and Associates, and Law Engineering.

To obtain documentation and an understanding of the structure of the privatization and the roles of the parties involved, interviews were conducted with current or former representatives of the following firms: Ellis, Baker and Porter (counsel for the Industrial Development Authority); Valley National Bank (the Trustee); Gust, Rosenfeld, Divelbess and Henderson (bond counsel);

Rauscher Pierce Refsnes, Incorporated (bond underwriter); and Ernst and Young (the Partnership's external auditors).

The president of Scottsdale Water Service, Inc. (a general partner) and a representative of CDM Development Corporation (a general partner) were contacted to obtain pertinent documents and clarification on the Partnership's position on various contract terms. Workpapers of the audit firm Ernst and Young were also examined to review the nature of the work performed and the conclusions reached on their assignments involving the Partnership. The assignments reviewed were those offered by the Partnership as evidence that they had complied with the terms of its Contract with the City.

This report was distributed to officials at the Partnership and the City's Water Resources Department for their review and written response. Submitted written responses can be found in Appendix B.

APPENDIX B

Written Responses



January 6, 1994

Cheryl Barcala
City Auditor
City of Scottsdale
7440 E. First Avenue
Scottsdale, AZ 85251

Dear Cheryl:

We concur with your findings and have proceeded to implement this recommendation.

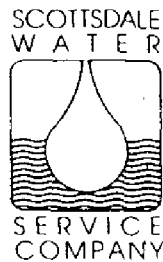
Sincerely,

A handwritten signature in dark ink, appearing to read "Leonard L. Dueker", is written over a circular stamp.

Leonard L. Dueker
General Manager
Water Resources Department

LLD:hs

9388 E. San Salvador • Scottsdale, Arizona 85258 • 391-5685



January 6, 1994

Ms. Cheryl Barcala
City Auditor's Office
3939 Civic Center Blvd
Scottsdale, AZ 85251

Audit Report on Scottsdale Water Service
Company Limited Partnership

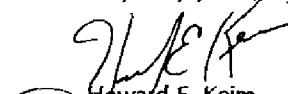
Dear Ms. Barcala:

We have reviewed the December 7, 1993 audit report relative to the 1984 Service Agreement between the City of Scottsdale (City) and the Scottsdale Water Service Company Limited Partnership (Partnership) for the treatment of water delivered to the City by the Central Arizona Project.

We are pleased to acknowledge that the differences between the City and the Partnership as to the interpretation of certain provisions of the Service Agreement and the related questions raised during the subject audit process have been satisfactorily resolved. We also would like to reiterate that the actions of the Partnership in interpreting and implementing the provisions of the Service Agreement have been conducted in good faith and in the best interests of the City.

We appreciate the opportunity to provide this written response to the subject audit report.

Very truly yours,


Howard E. Keim
President

16601 North Pima Road
Scottsdale, Arizona 85260
(602) 951-0913



CITY OF SCOTTSDALE

"The West's Most Western Town"

3939 N. Civic Center Blvd.

SCOTTSDALE, ARIZONA 85251

Office of the City Manager

January 7, 1994

TO: Cheryl Barcala, City Auditor

FROM: Dick Bowers, City Manager

RESPONSE TO AUDIT REPORT 8802C

I agree. Steps have been taken on complex and unique contractual arrangements to assure that the City's interests are served.

Reports Issued
Office of the City Auditor
Scottsdale, Arizona

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<u>Issue Date</u>	<u>Report Number</u>	<u>Report Title</u>
1993		
September	9103	WestWorld Contract Compliance
August	9201	City Clerk Operational Audit
May	8903.1	Scottsdale Cultural Council Contract Administration Progress
1992		
December	8902.1A	City Parcel Database
December	9010B	Dial In Security System Project Evaluation
October	8902.1 and 9002	Progress Since 1989 In Property Tax Management, City of Scottsdale, Maricopa County
1991		
December	9102	Tournament Players Club Contract Compliance and Related Issues
October	8802B	Utility Bill and Tariff Costs, Scottsdale Water Service Company, City of Scottsdale
August	9105	Scottsdale Police Department Imprest and RICO Financial and Related Operational Management Practices
May	9003	Scottsdale City Court Financial and Related Operational Management Practices

<u>Issue Date</u>	<u>Report Number</u>	<u>Report Title</u>
April	8802A	Utility Bill and Tariff Costs, City of Scottsdale
1990		
December	9005	Investigation of Internal Control Weaknesses in the Communications Services Section of the Office of Management Systems
September	8905	Office of Management Systems General Controls
September	9001	Attestation Audit on Urban Mass Transportation Administration Reports and Related Scottsdale Connection
April	9004	Investigation of Internal Control Weaknesses Involving Community Development Block Grant Funds and Other City Resources
April	8903	Scottsdale Cultural Council Contract Performance and Compliance
November	8904	Preliminary Survey Covering City of Scottsdale Automated Systems
September	8902	Property Tax Management Practices City of Scottsdale/Maricopa County
April	8901	Attestation Audit on Inventory Moved During Police Property and Evidence Room Relocation in February 1989
April	8801	Perquisite Management Practices